7.07 Impairments

Impairment of Long-Lived Assets Held for Use

Impairment of long-lived assets held for use occurs when the carrying amount of an asset is not recoverable and a write-off is needed. (ASC 360)

Examples

- A significant decrease in the market value of an asset.
- A significant change in an asset's physical condition or the extent or manner in which it is used.
- A significant adverse change in legal factors or in the business climate that affects the value of an asset.
- An accumulation of costs significantly in excess of the amount originally expected to acquire or construct the asset.
- A projection or forecast that demonstrates continuing losses associated with an asset.
- An expectation that it is more likely than not that the asset will be disposed of before the end of its expected useful life.

Impairment Testing

Impairment testing applies to asset groups as well as individual assets. The impairment is applied proportionately to all the long-lived assets in the asset group (but no asset is reduced below its fair market value).

The process of determining an impairment loss is as follows:

1. Review events or changes in circumstances for possible impairment (above). If none are identified, no further testing is required.
2. If the review indicates impairment, apply the **recoverability test**: if the sum of the **expected future net cash flows** from the long-lived asset is **less than** the **carrying amount** of the asset, an impairment has occurred.
3. The **impairment loss** is the amount by which the **carrying amount** exceeds the **fair value** of the asset. The fair value is the market value or the present value of future expected cash flows.

Note that estimated *future cash flows* are used to determine if impairment has occurred, but the asset is adjusted to its *estimated fair value*, **not** estimated future cash flows, once the determination has been made. The impairment loss, which appears on the income statement in income from continuing operations, may **NOT be restored** for an asset *held for use*.

Assume an asset has a carrying value of $600, the expected future net cash flows are $580, and the market value is $525. Since the $580 expected cash flow is less than the $600 carrying value, an impairment has occurred. The amount of the loss is 75 (ie, 600 carrying value – 525 market value). Now we calculate the future depreciation from the new $525 carrying value.

Impairment Loss (I/S)	75	
Accumulated Depreciation		75

Disclosures

- Description of impaired assets and circumstances which led to impairment
- Amount of impairment and manner in which fair value was determined
- Caption in income statement in which impairment loss is aggregated, if it is not presented separately

Impairment of Long-Lived Assets to Be Disposed of—Held for Sale

When assets are no longer being used in operations, they are reclassified on the balance sheet. They are taken out of property, plant, and equipment and are reported in ***Other assets*** and described as held for sale.

- When first transferred to the held-for-sale category, the amount is the *lower of* the asset's **carrying value** and its **net realizable value** (NRV), which is its estimated selling price less costs of disposal.
  - If NRV is lower, it becomes the new carrying value (CV) and a loss is recognized on the income statement in continuing operations.
  - If the old CV is lower, it remains as the CV and no loss is recognized.
- Assets held for sale are *not* depreciated.
- In subsequent periods, increases or decreases in the NRV are recognized:
  - The asset is increased or decreased to its NRV at the balance sheet date, provided it is not increased to an amount that exceeds its CV before the transfer.
  - The increases or decreases are recognized as gains or losses.
  - Thus, an asset held for disposal **can be written up or down** in future periods as long as the write-up is never greater than the carrying amount of the asset before the impairment.

Loss on planned disposition	700	
Equipment to be disposed of (other assets) **NRV**	1,500	
Accumulated Depreciation	3,800	
Equipment		6,000

Disposal of Fixed Assets

When a company disposes of a fixed asset, they will normally remove the original cost and accumulated depreciation, record any amounts received or due to them as a result of disposal, and recognize a gain or loss for the difference. The gain or loss is reported in continuing operations as part of other items.

If a client owns a machine with a cost of $10,000 and carrying amount of $3,000, and it is sold for $2,500 cash, the entry is:

Cash	2,500	
Loss on sale	500	
Accumulated Depreciation	7,000	
Machinery & equipment		10,000

Involuntary Conversion

Disposals include *destruction of property* as well as seizure by government entities as a result of condemnation or eminent domain actions. The accounting for these events is **identical to voluntary sales**, and GAAP does not allow deferral of gains or losses as a result of subsequent replacement of such property.

Assume that, on 9/15/X1, a fire destroyed a client's warehouse with an original cost of $1,000,000 and accumulated depreciation on the date of destruction of $225,000. Removal of debris cost $20,000. On 1/20/X2, the insurance company issued a check to the client for $1,200,000, and a new warehouse was built and completed on 6/30/X2 at a cost of $1,300,000. In 20X1, entries to account for the effects of the fire will have the following effect:

Due from insurance	1,200,000	
Accumulated Depreciation	225,000	
Involuntary conversion gain		405,000
Warehouse		1,000,000
Cash		20,000

In 20X2, the collection of the insurance payment and construction of the new warehouse result in the following:

Cash	1,200,000	
Due from insurance		1,200,000
Warehouse	1,300,000	
Cash		1,300,000

In determining the accumulated depreciation balance at the time of a disposal, the asset should reflect any depreciation in the current period prior to the time of the sale. Also, in determining the gain or loss, all costs associated with the sale should be included.

If an asset that is part of a group being depreciated under the composite method is sold or removed from service before the entire group has been fully depreciated, determining the asset's cost and accumulated depreciation may be impossible. In this case, the carrying value of the group is simply reduced by net proceeds (if any) resulting from disposal, and no gain or loss is recorded.